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April 30, 1990

# Pensions & Investments

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## AT DEADLINE

### Dispute engulfs Connecticut

The State of Connecticut Trust Funds, part owner of the Colt Firearms Division of Colt Industries Inc., is embroiled in a debate over the firm's plan to manufacture a new assault rifle.

Colt's plans spurred questions about using public pension funds to save the gun manufacturer, especially since the Legislature is proposing tougher license requirements on buyers of assault rifles.

### Exxon asked to do more

California State Comptroller Gray Davis, who oversees the California Public Employees' pension fund, plans to contact outside directors of Exxon to pressure management to strengthen its commitment to the environment. The fund is a major Exxon shareholder.

In an April 24 letter to Exxon Chairman Lawrence Rawl, Mr. Davis also recommended the company form a subsidiary dedicated to environmental restoration and protection, voluntarily file a report assessing its compliance with the Valdez Principles, and create an environmental audit team.

### Unions form realty trust

Four union pension funds in Kentucky — the $7.6 million Bricklayers Local 1, the $49 million State District Council of Carpenters, the $33 million Pipefitters Local 522 and the $19.8 million Plumbers & Gasfitters Local 107 — committed a total of $20 million to form Pension Fund Property Trust, an open-end real estate fund.

W. Lyman Case & Co. is the investment adviser.

### Firms top indexes

International and global managers surveyed by The WM Co. lost money but still outperformed the relative indexes during the first quarter, according to preliminary findings.

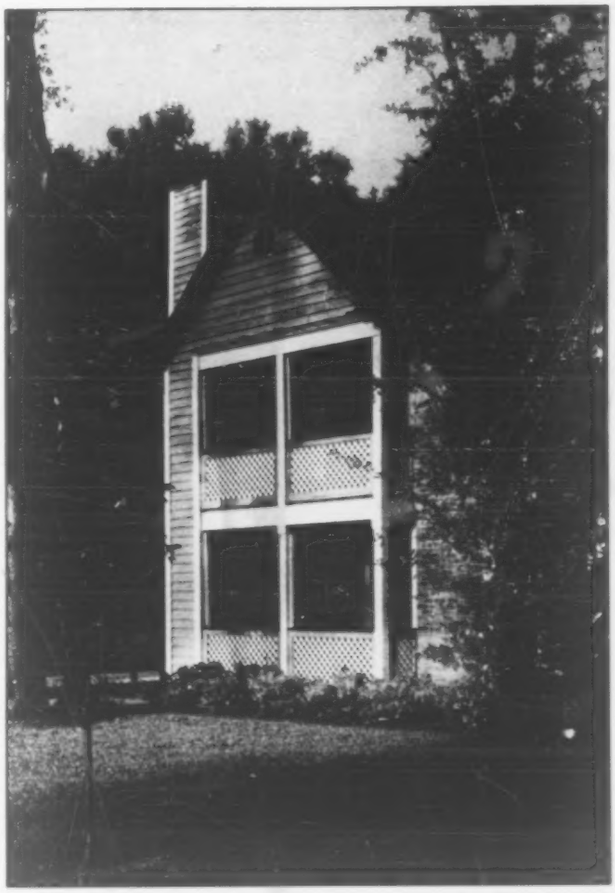
The median non-U.S. portfolio returned −8.4% and the 95th percentile returned −14%, while the EAFE Index returned −19.7%. The composite global return was −5.8%, compared to the World Index's −14.2%.

### Custodians hired

Swiss Bank Corp. hired Brown Brothers Harriman & Co. as its U.S. custodian. SBC said in March it was exiting the U.S. custody business. ... Claremont McKenna College tapped The Northern Trust Co. as custodian for $15 million of its $91 million endowment fund. ... The Alaska Permanent Fund selected Brown Brothers Harriman as custodian for the fund's international securities.

### Chase joins trust, custody

Chase Manhattan Bank has combined its master trust and master custody units into one business with assets of more than $150 billion, to be managed by Michael Mertz, vice president.



Pension funds are pumping a record amount of money into apartment investments.

# Apartment hunt

## Investors seek once-shunned property type

By Steve Hemmerick

Pension funds are plowing money into apartments, a property type many of them shunned just a few years ago.

The California Public Employees' Retirement System and the Ohio Public Employees' Retirement System are among the newest players in what many view as a shrewd investment in a generally shaky real estate market.

Pension funds pumped $300 million into multifamily housing in 1989 through commingled funds, the highest amount ever and a 240% increase from the $88 million invested in 1988, said Paul Saint-Pierre, president of Pension Realty Advisors, San Francisco. That doesn't count any direct, separate investments pension funds might have made.

This year, the $56 billion California fund is funneling $500 million into carefully selected apartment investments. Sentinel Real Estate Corp., New York, and Metric Institutional Realty Advisors, Foster City, Calif., will receive about $250 million each to invest in between 10 and 15 out of 100 apartment markets.

In addition, the $20 billion Ohio system, has invested $200 million in apartments, and is picking more up as opportunities arise.

Real estate advisers, meanwhile, are offering 29 commingled funds that would invest exclusively, or a significant amount of contributed dollars, in apartments.

About 12 advisers offered apartment funds in 1989, up from seven in 1988, said Mr. Saint-Pierre.

According to Joseph Diehl, executive director of the National Council of Real Estate Investment Fiduciaries, the apartment sector in 1980 made up 0.4% of the $2 billion Russell-NCREIF Property Index. By December 1985, the percentage decreased to 0.3% in the $10.8 billion index. As of December 1989, the latest available figure, apartments represented 0.7% of $15.8 billion.

Although no craze as yet, several factors are fueling the in-

*See* **Apartments** *on page 46*

# ESOP reduces threat to Conrail

By Trudy Ring

PHILADELPHIA — Consolidated Rail Corp., in a move widely viewed as an anti-takeover play, plans to join the growing list of companies making a public debt offering to finance an ESOP.

Conrail set up the leveraged employee stock ownership plan with about 5 million shares of preferred stock in exchange for a $288 million promissory note from the ESOP. A portion of the proceeds from the debt issue will be used to purchase stock, on the open market, to offset the dilution the ESOP otherwise would have caused.

The company has filed a shelf registration with the Securities and Exchange Commission for issuance of debt securities with an initial offering price not to exceed $1.25 billion. Terms will be determined by market conditions; underwriters may include Morgan Stanley & Co. Inc., New York, according to the filing.

Transportation industry analysts and ESOP experts said Conrail officials might have feared a hostile takeover following the recent expiration of limits on holdings in Conrail stock. Under the federal law that privatized the company, no entity other than another railroad company could hold more than 10% of Conrail's shares until three years after the sale of Conrail by the federal government. The three-year period was up about a month ago.

Analyst Joel Price, vice president-research at Donaldson, Lufkin & Jenrette Securities Inc., New York, said he considers the takeover fears unfounded, as Conrail recently has increased its debt about $700 million and decreased its cash reserves about $400 million. But, he added, "Fear is in the eye of the beholder."

An anti-takeover law recently passed in Pennsylvania is another deterrent to raiders, Mr. Price added.

David Binns, executive director of the ESOP Association, Washington, said Conrail, like many public companies, is interested in getting as much stock as possible into friendly hands.

Graeme Anne Lidgerwood, transportation analyst at First Boston Corp., agreed the ESOP might be a defensive move, but added it also creates an incentive for participating employees.

Conrail previously had an ESOP, which held 15% of the company's stock, when the federal government owned 85%. That ESOP was terminated in 1987, with employees reaping significant gains, Mr. Binns said.

A Shearson Lehman Hutton Inc. research report notes railroads are battling the effects of the economic slowdown, but expressed confidence they will be able to cut costs and show market gains. Conrail's stock declined 6% in price during the first quarter.

The ESOP will cover all nonunion and certain unionized employees of Conrail, according to documents filed with the SEC. Conrail officials declined to be interviewed.

Proceeds of the debt offering will be used to refinance the $700 million in short-term notes Conrail recently used to finance a Dutch auction tender offer for 22.3 million of its outstanding shares; to finance a $206 million open-market purchase of common stock (roughly 4.2 million shares)

*See* **Conrail** *on page 47*

# FASB sheds light

## Off-balance sheet financing revealed

By Marlene Givant Star

The Financial Accounting Standards Board's new requirement that companies disclose the risks of off-balance sheet financing will, for the first time, reveal to investors and security analysts how much industrial companies rely on the technique.

Once used almost exclusively by financial institutions, off-balance sheet financing — using such instruments as interest rate and currency swaps, loan commitments and options written on securities held and forward interest rate contracts — is growing more common among industrial firms.

Under FASB 105, financial statements for years ended after June 15 will have to disclose the types of off-balance sheet instruments, including principal amounts; collateral or other security, and any concentrations of risk. (Concentration refers to transactions that would be affected similarly by changes in management or the geographic, operating, economic or industrial environment.)

The revision was spurred by the

*See* **FASB** *on page 45*

## NEWS DIGEST

Photo by Alice Gatrik

**Elizabeth Holtzman, comptroller** of New York City, is among those protesting a decision by AT&T to cut funding to Planned Parenthood. Page 6.

**The Chemical Investment Group** has been put on the selling block by Chemical Banking Corp. Page 8.

**Shareholder rights are endangered** by the rash of anti-takeover legislation; investors ought to sell stocks incorporated in those states. Opinion. Page 16.

SPECIAL REPORT: GLOBAL INVESTING

**Pension funds worldwide** no longer are automatically turning to the United States as the country of first choice for investing, an indication that pension funds are becoming true global investors. Page 21.

FINANCING

**Off-balance sheet financing,** once the exclusive instrument of financial institutions, is finding a legion of new fans among industrial companies. Page 1.

**Consolidated Rail Corp.,** fearing a takeover, is joining the growing list of companies making a public debt offering to finance an ESOP. Page 1.

INTERNATIONAL

**The British Coal Pension Funds** are making a hostile takeover move for the largest investment trust in the United Kingdom. Page 3.

**European and Japanese** institutional investors are feeling the sting of the junk bond collapse and are reacting with activism. Page 3.

REAL ESTATE

**Apartments, once shunned** by pension funds, are fast becoming a hot real estate investment. Page 1.

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### International alert

Questionnaires for *Pensions & Investments'* annual directory of international and global investment advisers were mailed April 10. The deadline for inclusion in the directory, to be published June 25, is May 13. If you have accounts invested overseas and have not received a questionnaire, contact Christine Philip at (312) 649-5217.

# Defections hurt manager

## Duncan quits, L.A. County drops Pacific Century

By Steve Hemmerick

The Los Angeles County Employees Retirement Association is dropping Pacific Century Advisers Inc. as manager of a more than $100 million small-capitalization account following the resignation of the firm's valued chief investment officer, William "Beau" Duncan.

After resigning April 5, Mr. Duncan established his own money management firm, Duncan Capital Management, San Diego, with the senior trader at Pacific Century, Mark Freeman, and the operations supervisor, Rebecca LaFerney, who also resigned.

Charles Conrad, administrator for the Los Angeles fund, said his board notified PCA of its intention to terminate the firm after discussing the matter with its consultant, Callan Associates, San Francisco.

Another pension fund, the Dallas Police & Fire Pension Fund, which has a $28 million account with Pacific Century, will consider whether to continue with the firm after its consultant — Wilshire Associates, Santa Monica, Calif. — completes an already scheduled review of its equity investments.

Edward Hartmann, president and chief executive officer of Security Pacific Investment Group, Los Angeles, said he had not been told of the Los Angeles County fund's action, but would look into the matter.

Pacific Century, which manages

*See* **Duncan** *on page 44*

**William Duncan left Pacific Century Advisers to form his own money management firm.**

# 2 top CII officials are clashing

By Marcia Parker

WASHINGTON — Two top officials of the Council of Institutional Investors are clashing over the future of the group and a possible change in leadership.

At odds are Sarah Teslik, executive director, and Paul Quirk, chairman of the executive committee and executive director of the Massachusetts Pensions Reserve Investment Management Board.

Indeed, members attending the council's annual meeting here earlier this month said the conflict was played out in the corridors and between sessions in discussions over who should lead the organization.

Some say the two have a personality clash; others say it's a philosophical difference of opinion.

Ms. Teslik, whose contract is up for renewal July 1, acknowledges a problem exists, and says she believes Mr. Quirk is displeased with her performance. Mr. Quirk denies that, and says the friction comes from the rough-and-tumble debate under way over the council's future.

Both admit to having had differences of opinion in the past on the council's activities.

Ms. Teslik's performance is being reviewed by the executive committee as part of a routine examination to determine whether her contract should be renewed.

The executive committee also is charged with hammering out a new direction for the council. Mr. Quirk appointed Dale Hanson, chief executive of the California Public Employees' Retirement System, to head a strategic policy subcommittee to define an agenda for the 1990s.

Mr. Quirk categorically denies he wants Ms. Teslik's job, although that has been a rumor for some time in council circles. Some have said that when Massachusetts Gov. Michael Dukakis leaves office at the end of the year, Mr.

*See* **Clashing** *on page 47*

# Pension execs cool to 144A

By Joel Chernoff and Curtis Vosti

WASHINGTON — The Securities and Exchange Commission's approval of the landmark rule permitting vastly expanded trading of private placements was hailed by investment managers active in the market, but pension fund executives known to dabble in private placements were, for now, indifferent.

The opening up of the market through Rule 144A also will open the door for the National Association of Securities Dealers Inc.'s new PORTAL trading system.

The new rule is expected to affect foreign equity and debt as well as domestic corporate bonds. Initially, the greatest impact is expected on foreign issuers seeking to privately place equities with U.S. institutions.

Rule 144A limits participation in the less-regulated private placement market to investors with at least $100 million in securities under management. Dealers need only $10 million in securities.

"Pension funds our size see the ruling as a non-event," said David Bullett, vice president for the Teachers Insurance and Annuity Association, New York, which had $10 billion in private placements as of Sept. 30.

"I think the ruling will help bring liquidity and lower prices (to the private market). It will also attract more foreign investors to the U.S. private placement market," he said.

For CIGNA Corp., which completed $3 billion in private placements in 1989 and has $12 billion in total private placements, the new rule is "a push rather than a shove" for the private placement business, according to Augustine Demeo, vice president of CIGNA Investments Inc., Hartford, Conn.

"More customers queuing up for money from us is a good thing," said James Coxon, senior vice president of CIGNA Corp.

While the ruling is seen as a positive by David Blood, vice president and manager of the private capital markets desk at Goldman, Sachs & Co. Inc., New York, he acknowledged pension funds may hold back their support.

"The market will develop over time," Mr. Blood said. "The scope of the development depends on

*See* **Rule 144A** *on page 46*

**Activity on the PORTAL trading system is expected to pick up with the approval of Rule 144A for private placements.**

# Lockheed ESOP faces legal storm

## Experts say challenge won't fly

**By Joel Chernoff**

LOS ANGELES — Harold Simmons' challenge of the Lockheed Corp. proxy vote might provide the first test as to whether certain defensive ESOPs will fly in court.

The Dallas-based investor's lawsuit over how the ESOP's shares were voted in the fight for control of the company, however, may encounter a shaky ride. Lawyers familiar with the Lockheed employee stock ownership plan believe the plan's design and the conduct of its trustee, U.S. Trust Co. of California, address issues raised by the Department of Labor in voting participant shares.

**Harold Simmons is charging Lockeed's ESOP is an illegal entrenchment device.**

These factors are likely to provide legal support for the ESOP's vote and probably will prevent the Labor Department from intervening in the case, pension experts believe.

The design of the Lockheed ESOP is "quite cunning," acknowledged Robert A.G. Monks, president of Institutional Shareholder Services Inc., Washington, and a former Labor Department pension chief. Mr. Monks' firm supported Mr. Simmons in the proxy vote.

Still, Mr. Simmons has a number of other legal legs to stand on, and no one would count him out.

Dozens of ESOPs have been put in place by U.S. corporations since Polaroid Corp.'s ESOP helped thwart a hostile takeover by Shamrock Holdings Inc. in March 1989.

The merger mania of the 1980s has withered, leading many experts to believe the battleground for corporate for control will revert to the traditional proxy contest. But how ESOP shares are voted — particularly those not yet allocated to participants' accounts — remains in dispute, and may have an important bearing for future proxy battles.

The April 19 lawsuit, filed in U.S. District Court in Los Angeles by Simmons-controlled NL Industries against Lockheed and its directors, may provide the first major test of those issues.

The Lockheed ESOP was created last April, and has 18.9% of the company's stock. NL charged the creation of the ESOP was an illegal entrenchment device, that the ESOP's 12.2 million shares should not be counted in the recent proxy vote and that voting irregularities — including some by the ESOP's trustee — affected the tallies.

As Lockheed's largest investor with 18.94% of its common stock, NL wants the court to nullify the ESOP's votes, count disregarded votes in Mr. Simmons' favor and have his own slate be recognized as directors. Alternatively, Mr. Simmons called for a new election in which no ESOP shares would be counted. Lockheed's nominees won between 58% and 61% of the vote.

The Lockheed ESOP relies upon a novel arrangement that passes voting rights to participants for both the 1 million shares of employer-allocated stock to their accounts and the 10 million shares not yet allocated and sitting in a "suspense" account. (Another 800,000 shares were purchased by employees through contributions to the ESOP.)

In marked contrast to the situation encountered a year ago in Polaroid's ESOP, the Lockheed ESOP did not rely on a mechanical test for determining the vote of shares not allocated to participants.

Under the Polaroid ESOP, unallocated shares were voted proportionate to the vote of the allocated stock. That method raised the hackles of the Labor Department, which maintained the plan trustee could not sidestep its fiduciary duties through adherence to a rigid voting formula.

But Lockheed used another Labor Department position in designing its ESOP. The department said it is the trustee's job to manage and control plan assets — except where the participant has been given authority to vote the allocated shares.

Lockheed didn't stop at giving participants the right to vote their allocated shares: The company made them named fiduciaries for the non-allocated shares as well, permitting them to cast ballots.

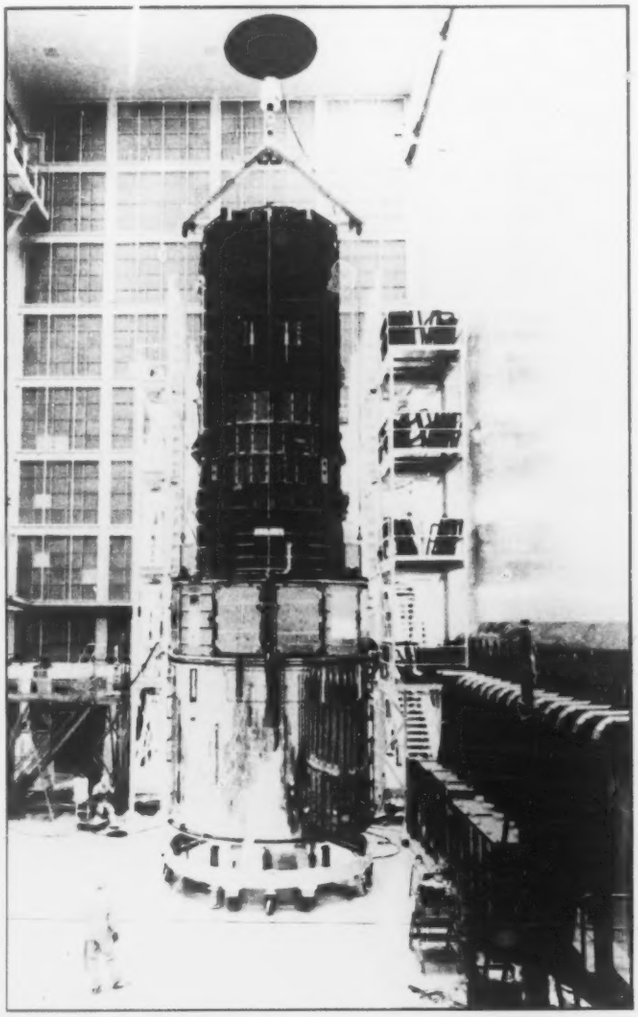
The plan "tracks the Labor Department's position and goes one step further," noted Steve Sacher, a pension lawyer with Johnson & Gibbs, Washington.

Showing that independent voting decisions were made on the ESOP stock, participants were given separate proxy votes for the allocated and unallocated shares, explained Ronald S. Rizzo, a partner in the law firm of Jones, Day, Reavis & Pogue, Los Angeles, which represents U.S. Trust.

Voting results for the allocated and unallocated shares differed on a proportionate basis, Mr. Rizzo said. A breakdown was not available.

In addition, U.S. Trust took another action that likely would give the Labor Department pause before intervening. Following the direction of the department's stand in the Polaroid case, the trustee voted the 30% of the allocated shares that participants had

*See* **Lockheed ESOP** *on page 47*



**Lockheed, which had a hand in deploying the Hubble Space Telescope into orbit, took several steps to ensure its ESOP does not run afoul of the Department of Labor.**

# British Coal bids for trust

**By Margaret Price**

LONDON — British Coal's pension fund this week is expected to make its formal hostile bid worth about $1.68 billion for Globe Investment Trust PLC, Britain's largest investment trust.

The move, if completed, would represent the roughly $20 billion fund's fourth acquisition of an investment trust. Previous acquisitions were those of Touche Remnant Industrial & General, Drayton Premier and a controlling interest in British Investment Trust.

London-based Globe has about $1.96 billion in investment trusts and also manages about $1.3 billion of pension assets through its Globe Morley subsidiary.

Details were limited on why British Coal wanted to acquire Globe, but according to a release, "The acquisition . . . enables the British Coal pension funds to increase their holdings in an investment trust where they already have a significant shareholding, at a discount to the value of the underlying portfolio."

Some analysts suggested the strategy was to employ an efficient way of investing in the stock market. "They are looking to put nearly a half-billion pounds into the stock market. To do that (directly) without driving up prices would be difficult," said John Korwin-Szymanowski, investment trust analyst at S.G. Warburg & Co., London. An easier, cheaper way "would be to take over the funds that have those stocks," he said.

With nearly a 34% stake in Globe, British Coal is the trust's largest single shareholder. The takeover bid was triggered after the funds, which previously had a 28.8% stake in Globe, bought another 5% of its stock late in the week beginning April 15. By British law, a stock holding of 30% in a company automatically requires the investor to make an offer to all other company shareholders.

For its part, Globe is fighting the bid and has advised its shareholders to "take no action in respect of the proposed offer." The company said the offer of 1.91 pence per Globe share, about $3.11, is "wholly inadequate in that it fails to reflect Globe's historic performance, its inherent value and its future prospects."

Globe is expected to protest the bid to the governmental Office of Fair Trading, which could request an investigation by the Monopolies and Mergers Commission. ■

# 'Junk' spurs foreign activism

**By Marcia Parker**

Stung by the collapse of the U.S. junk bond market, European and Japanese institutional investors of billions of dollars in illiquid junk bonds issued by U.S. companies have been prodded into becoming more like their activist brethren in the United States.

Indeed, these overseas investors are joining creditor committees and agitating for stronger covenants and stricter disclosure to protect them in the future.

Little attention has been focused on the fact that many U.S. companies' junk bonds have been affected by the turmoil here. The public Eurojunk market is a nascent one, and few European or Japanese junk bond buyers are bemoaning its apparent demise.

Moreover, some bankers speculate the failure of the public high-yield market will give the growing overseas private market a boost. A number of mezzanine funds raised largely from institutional investors have cropped up in recent years.

The bulk of the foreign buyers did not seek to buy junk bonds; many of their purchases began as investment-grade bonds, but declined or suffered ill financial health. But many issuers are in good shape, and their junk bonds are rated at the higher quality end of the ratings.

Foreign bondholders historically have not been as aggressive as their U.S. counterparts in filling their portfolios with junk bonds or asserting their rights in the face of plummeting values of their holdings and defaults by U.S. issuers such as Coleco Industries Inc. and Southmark Corp.

While no one is saying the era of activism is dawning in European and Japanese bondholder circles, there are small signs the historical

**A sampling of speculative-grade Swiss Franc bonds**

(As of March 14)

| Company name | Issue date | Issue amount ($ millions) | Coupon | Date of maturity |
|---|---|---|---|---|
| Charter Medical | 11/14/85 | 66.0 | 6.000 | 12/12/95 |
| Coleco Industries | 05/03/85 | 80.0 | 6.500 | 06/12/93 |
| Flexivan Leasing | 08/05/86 | 100.0 | 6.000 | 08/05/96 |
| Kinder-Care | 09/06/86 | 62.5 | 6.000 | 04/11/96 |
| Kinder-Care | 07/05/85 | 130.0 | 5.750 | 07/29/98 |
| Owens-Corning | 10/15/86 | 105.0 | 5.375 | 11/26/00 |
| Pan Am | 08/19/86 | 100.0 | 8.500 | 07/19/95 |
| RJR Nabisco | 05/09/86 | 200.0 | 5.375 | 08/17/01 |
| Safeway Stores | 04/02/86 | 100.0 | 6.250 | 04/03/01 |
| Southmark | 07/17/85 | 120.0 | 6.250 | 08/12/93 |
| Southmark | 08/01/87 | 100.0 | 5.625 | 07/14/94 |
| Texas Eastern | 09/17/86 | 100.0 | 6.750 | 10/19/96 |
| Wang Laboratories | 08/21/84 | 200.0 | 4.750 | 08/21/96 |
| Wang Laboratories | 02/19/85 | 200.0 | 4.750 | 02/20/00 |

Source: Moody's Investors Service, New York

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# AT&T charity cut angers NYC fund

By Trudy Ring

NEW YORK — American Telephone & Telegraph Co.'s decision to discontinue funding the Planned Parenthood Federation of America has aroused the wrath of one of AT&T's largest shareholders.

Trustees of the $17 billion New York City Employees' Retirement System, which owns 3 million shares — or about 1% — of AT&T, said they are "deeply disturbed" by the decision, and fear it will hinder Planned Parenthood's ability to prevent unwanted pregnancies. The trustees made the statements in a letter to AT&T Chairman Robert E. Allen.

The letter was signed by Elizabeth Holtzman, New York City comptroller, and trustees. It said AT&T disenfranchised its shareholders by making the decision to stop the funding before the matter came to a vote at its recent annual meeting. An individual shareholder had submitted a resolution calling for AT&T to refrain from supporting organizations that endorse, counsel on or perform abortions.

The fund has not received a response from AT&T, but a spokesman said the company made the decision because of Planned Parenthood's increasingly political nature, not because of the shareholder resolution or the organization's position on abortion.

AT&T's philanthropic arm, the AT&T Foundation, gave Planned Parenthood $50,000 this year; its donations to the organization during the past 25 years total between $400,000 and $500,000, company spokesman Burke Stinson said.

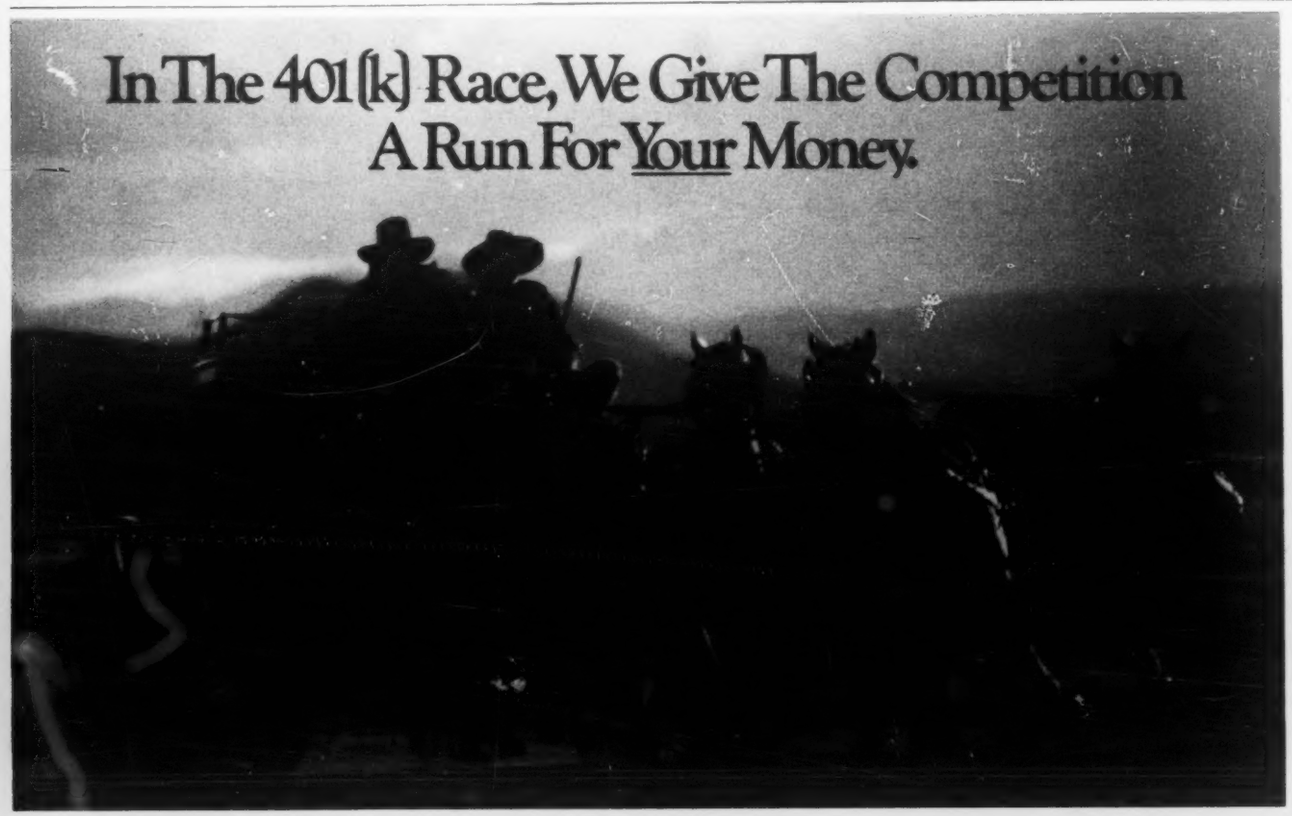
It will discontinue the contributions, effective next year, because of Planned Parenthood's decision to become involved, for the first time, in congressional races where candidates' views on access to abortion are an issue, Mr. Stinson said. "We did not want to mix philanthropy and politics," he said.

Mr. Stinson added AT&T, in its proxy material, called for shareholders to vote against the anti-abortion resolution, which 94.5% of them did.

AT&T's contributions to Planned Parenthood did not go toward abortion services, but rather for educational programs designed to prevent teen-age pregnancy. AT&T is continuing to fund similar programs through other, less political organizations, Mr. Stinson said.

A spokeswoman for the New York City system questioned whether Planned Parenthood's political activity should have been a problem for AT&T; the organization's education and pregnancy prevention programs are separate from its political efforts, she said.

The letter also said trustees are concerned that AT&T's action may cause the value of its stock to fall, as top management will be forced to spend time responding to negative publicity instead of focusing on corporate performance. Also, several organizations have threatened to boycott AT&T, the letter said. ■

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WELLS FARGO BANK

## CORRECTIONS & CLARIFICATIONS

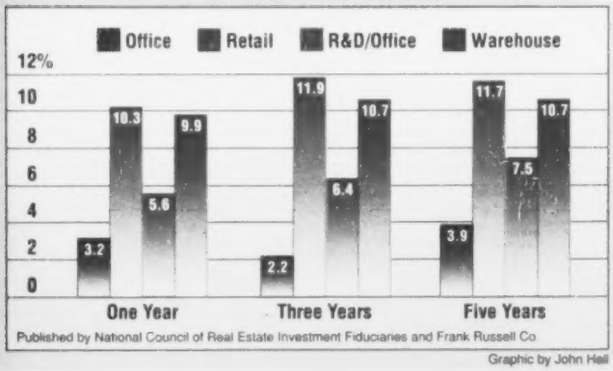
• The one-, three- and five-year returns for the **FT-A European & Pacific Index** reported in the Feb. 19 **PIPER/PIPER+** section for periods ended Dec. 31 were incorrect. The correct figures are 11.3%, a compound annualized 21.9% and a compound annualized 36.7%, respectively.

• Funding for **Ametek Inc.**'s $39 million account with Oak Hall Capital Advisors Inc. did not come from cash, as was reported in the April 2 issue. The assets had been managed by the predecessor firm to Oak Hall, which recently renamed itself.

## Russell-NCREIF Property Index

(Returns by property type)

Periods ended Dec. 31




Published by National Council of Real Estate Investment Fiduciaries and Frank Russell Co.

Graphic by John Hall

WALL STREET

## A poor ending for securities firms

■ Declines in trading profits and values of positions in investment accounts resulted in poor fourth-quarter results for U.S. securities firms.

Trading and investment accounts are among the key revenue sources of securities firms, along with mergers and acquisition activity and private placement fees.

According to a report by Jeffrey M. Schaefer, senior vice president-research of the Securities Industry Association, trading profits dropped to $2.7 billion in the fourth quarter of 1989, the lowest profits for any quarter of the year.

Investment accounts lost $221 million in the quarter vs. a $308 million profit the previous quarter, a reflection of declines in both stock and bond prices.

But the corporate debt market has rewarded investors this year. In the first two months of 1990 institutional net purchases surged to $840.6 million daily compared with $565 million in 1989. January saw the highest monthly net purchase figure since August 1987 and even surpassed 1986's record daily average of $859.7 million.

"Clearly institutions were attracted to fixed-income securities as interest rates climbed throughout January and February, finishing up about 60 basis points over December," the report said.

PUBLIC FUNDS

## Iowa combining fire, police funds

■ The Iowa Legislature approved a bill consolidating 87 local Iowa fire and police officers' pension plans into a unified statewide system effective January 1992.

Gov. Terry Branstad is expected to sign the bill in early May.

State Treasurer Michael Fitzgerald said he has not seen a final version of the bill approved by legislative conference committee, but said the consolidation should create a plan with approximately $500 million in assets.

The new system, he said, would be managed by a 13-person board of trustees.

Greg Kusak, deputy administrator for benefits at the Iowa Public Employees Retirement System, said the new system was created partly because of legislative frustration at a lack of standardized reporting and actuarial information concerning the retirement systems.

INTERNATIONAL

## Canadians urged to move slowly

■ Frank Russell Canada is cautioning its 27 clients not to rush to increase international investments.

The minister of finance has proposed allowing Canadian pension funds to invest up to 20% of assets internationally over the course of five years. Now, funds may invest only 10% of their assets internationally without penalty. Any investments over that amount are subject to a 1% per month compounded tax.

The Canadian parliamentary system, with the party in power having a working majority in the Legislature, makes it probable the law will pass, eventually.

But in a letter to its clients, the consulting firm cautioned the proposal, included in this year's budget message, has not yet become law, and they should wait lest they be hit with the "onerous" penalty.

"Last year's budget hasn't even been passed yet," said Beth Morris, a Russell consultant.

INVESTING

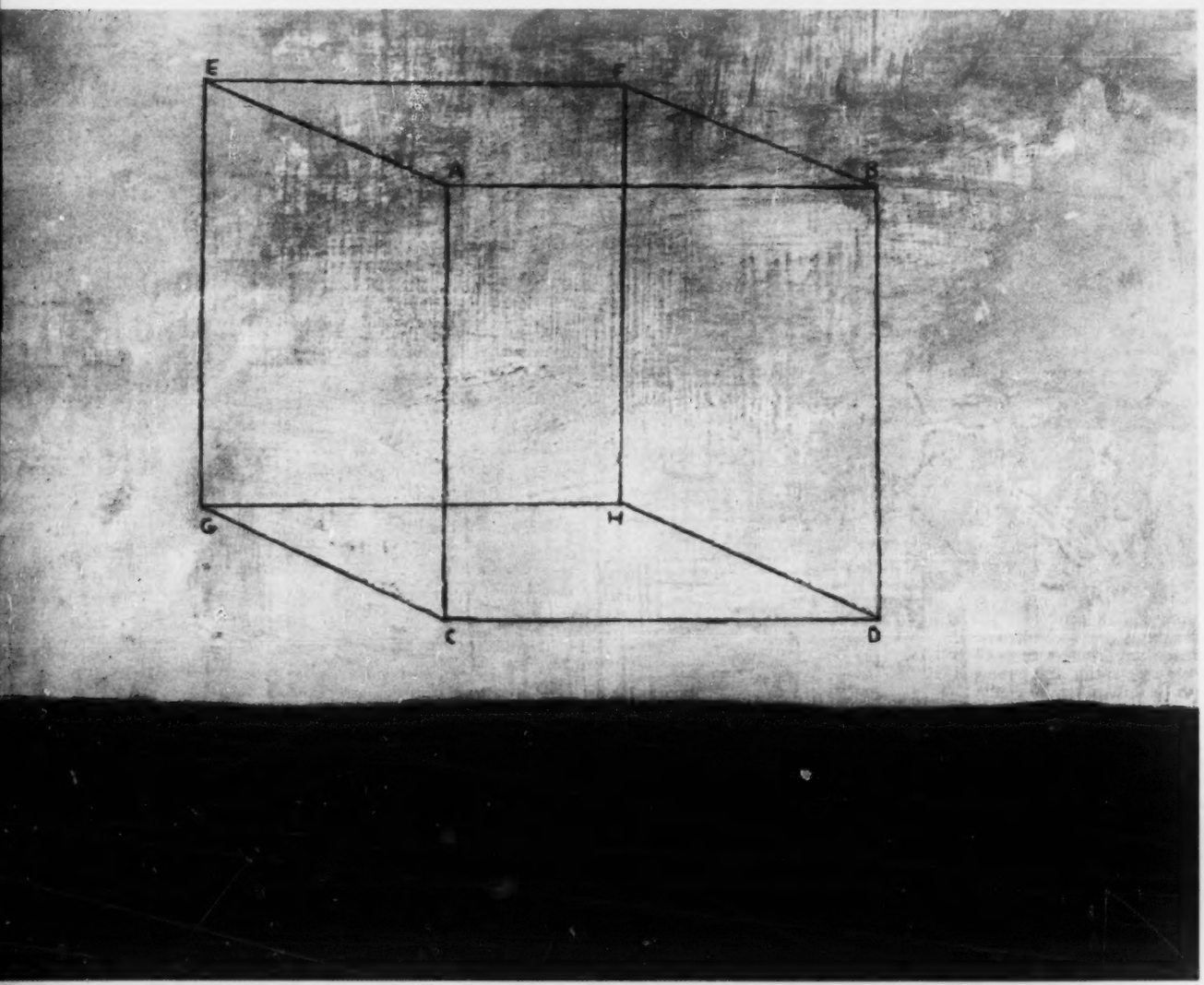
## And you thought FIFO was tough

■ Hopelessly hung up on defense industry acronyms? If so, Gary Reich has the answer.

Mr. Reich, aerospace and defense electronics analyst at Shearson Lehman Hutton Inc., produces an annual guide that lists, alphabetically, hundreds of acronyms.

Among the listings are ALCEP (AUTOSEVOCOM Life Cycle Extension Program); JINTACCS (Joint Interoperability of Tactical Command and Control Systems); and TOW (Tube-launched, Optically Tracked, Wire-Guided Antitank Missile).

Only one thing is missing: Many readers need an explanation of the words the acronyms represent..

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# Pigeonhole mentality and special benchmarks

By F.J. Gould

Illustration by Douglas A. Bowles

At great cost to their pension fund clients, influential consultants have created a thriving business in pigeonholing active equity managers into simple investment strategies.

This pigeonhole mentality originated the widely used peer-group styles and peer-group performance measurement. The latest form of the pigeonhole metamorphosis involves the creation of expensive and often nonsensical specialized benchmark portfolios.

To the pigeonhole thinking of consultants, and of their pension sponsor adherents, it's no longer suitable to compare a manager's performance against the Standard & Poor's 500 Stock Index. Now, say the consultants, a pension sponsor needs to develop a customized equity benchmark unique to each manager's investment style.

Consider this scenario: A sponsor hires a domestic equity manager who over time, in this sponsor's thinking, can outperform the S&P 500 on a risk- and cost-adjusted basis. The sponsor's consultant pigeonholes this new manager as a "value" manager. The consultant tells the sponsor his equity target, the S&P 500, is irrelevant with respect to enlightened performance measurement. Because the manager has a value style, he must be compared to the universe of other value managers. Further refining the pigeonholing concept, the consultant tells the sponsor to compare the manager to a specially developed benchmark of stocks, supposedly consisting of that manager's selection universe. After all, the consultant and sponsor have to separate luck from skill. Anyone knows that if value is out of style, you can't expect the manager to do as well as the S&P 500; and if value is in style, well, maybe the manager doesn't deserve credit for the performance.

I'm astonished so many sponsors are taken in by this fast talk. A specialized value benchmark may have a place for a value manager who was hired because he is a value manager. But if I believe the value manager should outperform my broad benchmark, namely the S&P 500, then that is unequivocally how I should measure the manager's performance. This doesn't mean I expect the manager to beat the S&P 500 every year. What is meaningful is the extent to which, over time, the manager's actual performance deviates from his anticipated performance.

Unfortunately, the pigeonhole mentality leads to a different prescription. Consultants argue that instead of hiring the active value manager the sponsor could invest in a passive specialized value benchmark. That is certainly true. So the sponsor should ask: What performs better relative to the S&P 500? The active value manager, or the specialized passive value benchmark?

The sponsor should base his decision whether to invest in the specialized value benchmark as a low-cost passive alternative to the active manager on the following comparison: performance of the specialized benchmark relative to the S&P 500 vs. performance of the active manager relative to the S&P 500. In other words, the performance of the manager relative to the specialized benchmark is a red herring.

It is important in my scenario that the value manager was hired not because he is a value manager, but because he is supposed to outperform the broad market, namely, the S&P 500. In this context, all that matters is the risk-adjusted returns relative to the S&P 500. Of conceptual importance is that relative to the S&P 500, the active value manager's portfolio may have risk-adjusted returns better than those of the specialized value benchmark. At the same time, the active portfolio may show returns lower than those of the benchmark when viewed on an unadjusted basis.

The pigeonhole simplicity leads to a world of sponsors overwhelmed with specialized benchmarks. A logical extension is the disappearance of active management.

Instead, we might envision a universe of ready-made competing specialized benchmark portfolios, each claiming to outperform the other. The aggregate portfolio resembles a modular stereo system and the potential for adding innumerable specialized high-tech components. Just as a stereo's amplifiers lead to more specialized pre-amps and woofers lead to sub-woofers, one can imagine growth portfolios leading to more specialized high-growth portfolios and so on. It becomes an endless effort to break down the market into more and more refined components — or pigeonholes. ■

*F.J. Gould is principal of Investment Research Co., Chicago, and professor in the University of Chicago's Graduate School of Business.*

## LETTERS TO THE EDITOR

### Index arbitrage is poison

■ Stanley Shopkorn's self-serving article in the Jan. 8 Commentary page implies that if commissions for firms such as his were higher, there would be no index arbitrage and no evanescent volatility.

He asserts the growth of indexation and momentum investing are the real generators of volatility. Just how does the low-transaction nature of indexation create added volatility? It's laughable to claim "momentum" investing has supplanted value investing: are there any managers who don't claim to be "value" investors?

Mr. Shopkorn goes on to say that to criticize index arbitrage as a source of stock price movements divorced from fundamental reality is misplaced, since technical analysis approaches are "divorced from fundamentals" as well. One would hope the vice-chairman of Salomon Brothers understands the basic premise of technical analysis is that fundamentals are reflected in stock prices and price movements. The movement of fundamentals and their impact on investor sentiment is simply "read" through technical approaches.

This is a far cry from price movements caused by the mathematical divergence from a yield-discounted normal spread of futures to equities. The comparison of technical analysis and index arbitrage as two similar generators of volatility through abandonment of fundamentals is a devious analogy.

The real distortions in Mr. Shopkorn's case emerge when he associates index arbitrage and the firms that operate with it as "providers" of liquidity. Adding liquidity is not simply a matter of adding a participant or dollars in motion in the marketplace. Liquidity has always meant the ability of participants in a market to buy and sell without disrupting the continuity of pricing. This is what New York Stock Exchange specialists are charged to do.

We are invited to pay higher commissions so that Mr. Shopkorn and other block traders can do a better job of providing liquidity. This type of transaction is an act of principal risk-taking, and not an area where commissions should be involved.

No one supports index arbitrage except those who directly profit from it. Index arbitrage is like the tiny coral snake. It kills through a small dose of potent toxin, rather than strangulation or smothering. If you see one, you will not walk down the path across which it lays. Just ask any institutional trader if he or she would like to buy equities when the futures trade at a discount.

**Lowell Miller**
President
Miller/Howard Investments Inc.
Woodstock, N.Y.

### Vanguard reports growth

■ I read *Pensions & Investments*' Scorecard report (Feb. 5) with great interest, but was sorry to see that for whatever reason Vanguard's figures were not included.

I thought your readers would be interested to know that, as a leader in the retirement plan marketplace, The Vanguard Group has grown to a position of importance, as evidenced by the following: new GIC business (net) was $450 million; new equity business (net) was $925 million; new fixed-income business (net) was $421 million; new balanced business (net) was $263 million; and new equity indexed fund business (net) was $273 million.

At Vanguard, we measure our success by the faith our clients place in us. We continue to look forward to improving our position in the institutional market.

**James H. Gately**
Senior Vice President-Institutional
The Vanguard Group
Valley Forge, Pa.

### Portability threatens loyalty

■ Regarding the Feb. 5 commentary "Pension portability: No easy solution": This article, as do most on this subject, totally ignores the basic reason an employer establishes a pension program.

There is a basic feeling that employees become worth more to the employer as their experience and time with that employer grows. In recognition of that increased worth, and to encourage stability, the pension is established to reward an employee who stays with his current employer until retirement.

Some employees prefer to change jobs every three or four years. Rather than stay with their current employer and get the usual 5% or 6% wage increase, they job shop, find someone who will give them a 10% or 15% pay jump, and change jobs, over and over. In exchange for their pension they get a big jump in pay.

To suggest that the employer of those who change jobs every three or four years might fund (and continue to fund) that employee's pension at the same level as he funds the pension of those who stay with him for their entire working career is to completely ignore the basic reason an employer establishes a pension plan. The employer is much better served by spending his money on current employees — not jobhoppers.

If total equity for all retirees is the goal, let's just double or triple the employer's (and perhaps the employee's) Social Security contribution and the benefit, which is mandatory and completely portable, and eliminate all pensions, 401(k)s, etc. Let's admit that the employer no longer has any control over the policies or funding of his pension, and nothing to gain from providing one, and transfer the entire program into another government mandate, which should then be funded primarily by the employer — one step closer to socialism!

**W.C. Payne**
Safety director
Yates Construction Co. Inc.
Stokesdale, N.C.

### Tracking EAFE index

■ We would like to express our disappointment over the incorrect returns reported to Pensions & Investments Performance Evaluation Reports for our international EAFE stock index fund (*P&I*, Feb. 19). Because we pride ourselves on our ability to consistently track the index with minimal tracking error, we think it is important to bring this correction to your attention.

The correct three-month return for the fund was 4.6%, matching the index.

The one-year return was 10.8%, again matching the index.

The three-year return was 20.9% compared with 21.2% for the index.

**Peter E. Braun**
Vice president
State Street Bank and Trust Co.
Boston

### FT-EuroPac indexing

■ The one-year return of the Travelers International Index Fund, which tracks the returns of the FT-EuroPac, was reported correctly in the Feb. 19 issue as 11.2%.

Unfortunately, you incorrectly reported the one-year FT-EuroPac return as 10.8%. The actual return for the year ended Dec. 31 was 11.3%.

As an index fund manager, we are happy to accept the 10 basis points of tracking error rather than 40 basis points of un desirable alpha.

With many investment strategies, consistent performance is a virtue.

**Mark N. Peters**
Marketing manager
TIMCO
Hartford, Conn.

*Editor's note: The returns for the FT-EuroPac were transmitted incorrectly to Rogers, Casey & Associates, which compiles PIPER. The correct returns are listed on page 6.*

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# Bondholders

*Continued from page 3*

passivism is giving way to a more assertive stance and greater sensitivity to credit quality.

Wilbur Ross, senior managing director at Rothschild Inc., New York, said he's seeing a big change.

Rothschild, through its bankruptcy advisory practice, has represented many well-known U.S. companies in bankruptcy, including Drexel Burnham Lambert Inc. and Coleco.

Mr. Ross noted Drexel's major creditors include a large number of Japanese and other non-U.S. financial institutions, many of which own junk bonds underwritten by Drexel.

"Drexel's was the first (major company) creditors committee whose members are predominantly non-U.S.," Mr. Ross said. "Historically, foreign institutions have been passive in their representation. None of the offshore institutions on the Drexel committee has missed a meeting."

Through the years, U.S. companies such as Kinder-Care Inc., Pan Am Corp., RJR Nabisco Inc., Safeway Stores, Southmark and Wang Laboratories Inc. have issued junk bonds in the Euromarkets to attract a wider group of investors in Europe and Japan. Drexel, the now-defunct kingpin of the junk bond world, was instrumental in placing many of these bonds with European and Japanese institutional investors.

Reliable data on the quantity of junk bonds held by foreign institutions isn't available, but investment bankers say pension funds, money managers and other institutions hold the bulk.

Calls to more than 12 foreign institutional investors did not find a single one that acknowledged holding U.S. company junk bonds. But all of them said they are seeing the first signs of increased bondholder activism.

Rating agency officials, investment bankers, money managers and pension funds overseas say European and Japanese investors who bought these bonds either are sitting on them in the hopes of a turnaround or are trying to unload them. Many are having a hard time finding buyers.

Because the overseas junk bond market is just getting off the ground, the secondary market is relatively small and illiquid. The recent trend away from highly leveraged transactions is likely to continue and already is reducing the supply of high-yield paper from U.S. companies. With the junk bond market collapse at home, U.S. companies aren't issuing junk bonds at home or abroad.

"There's more concern about event risk. There's a whole new look at covenants," said Jeff Hayes, senior vice president-international bond investments at UBS-Phillips & Drew, London.

Speculative-grade debt comprises less than 2% of the estimated outstanding Euromarket debt, according to Moody's Investors Service, New York. Moody's rates $13.6 billion of non-investment-grade debt in the Euromarket, a small amount when compared with the $210 billion outstanding in speculative-grade debt in the United States.

About 71% or $9.6 billion of the rated speculative-grade debt in the Euromarket has been issued by U.S. issuers. The rest of the issuers are U.K. and Australian companies, the rating agency said.

Because of special events such as leveraged buy-outs, recapitalizations and defaults in the United States, the Eurobonds of some issuers have been downgraded, resulting in some secondary market losses for some investors. About 45% or $6.2 billion of the rated speculative-rate Eurodebt originally was investment grade, Moody's said. All were U.S. issuers.

Moody's estimates 68% or $9.3 billion is in U.S. dollars, 15% or $2 billion in Swiss francs; 7% or $950 million in deutsche marks; and 4.7% or $639 million in yen.

Switzerland, which has been a major source of money for international borrowers of high credit quality, has seen an increase in the number of junk bonds either issued there or that have fallen in credit quality, the rating agency said. About 3.8% of all listed Swiss foreign bonds are rated below Ba1, including original issues as well as "fallen angel" junk bonds, according to Moody's. That makes the Swiss franc junk bond sector proportionately larger than the Eurojunk market.

Some 66% of rated Swiss franc junk bonds are obligations of U.S. companies, according to Moody's.

Nearly all the bonds are straight issues with no equity features. A large portion — about 40% — of the market consists of fallen angel bonds, which fell to speculative-grade status after issuance into the Swiss market. One, Wang Laboratories, dropped to speculative-grade status because of a fundamental decline in credit quality.

Nine other issuers affecting some 1.5 billion Swiss francs fell from grace following special events such as RJR Nabisco Inc.'s leveraged buy-out and a major acquisition by American Medical International.

A large Swiss money manager who did not want to be identified said most Swiss investors are hanging on to the bonds and hoping workouts will revive them. He said bondholders are getting more vocal in speaking up for their rights as members of creditor committees and are speaking out earlier if they sense trouble. ■

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